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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

No. 384

In the Matter of

SAMUEL CHAPMAN, INC.,

Bankrupt,

UNITED STATES OF AMERICA,

Claimant-Respondent,

—against—

NEW YORK CREDIT MEN'S ADJUSTMENT BUREAU, INC.,

Trustee-Petitioner.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT AND APPENDIX

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IN THE

Supreme Court of the United States

October Term, 1968

No.

In the Matter of

SAMUEL CHAPMAN, INC.,

Bankrupt,

UNITED STATES OF AMERICA,

Claimant-Respondent,

—against—

NEW YORK CREDIT MEN'S ADJUSTMENT BUREAU, INC.,

Trustee-Petitioner.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

New York Credit Men's Adjustment Bureau, Inc., Petitioner, prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit, entered in the above entitled case on May 10, 1968.

Citations to Opinions Below

The opinion of the Court of Appeals is reported at 394 F. 2d 340 (1968). It is printed in the Appendix (A4-7). The opinion of the District Court is reported at 270 F. Supp. 1021 (1967). It is printed in the Appendix (A9-13). The opinion of the Referee is not reported. It is printed in the Appendix (A14-18).

Jurisdiction

The judgment of the Court of Appeals was entered on May 10, 1968. The jurisdiction of this Court is invoked under *Bankruptcy Act*, §24(c), 11 U.S.C. §47(c) and 28 U.S.C. §1254(1).

Questions Presented

Is a claim for tax penalties incurred by a debtor in possession in a Chapter XI arrangement proceeding allowable against the bankrupt estate in a superseding liquidating bankruptcy? (Ct. App., A4; D.C., A9; Ref., A14).

Statutes Involved

The statutory provisions involved are: 11 U.S.C. §§93j, 702, 742, 743, 778(4)c, 781(3) and 28 U.SC. §960 (A1-A3).

Statement

On January 17, 1964, Samuel Chapman, Inc., as Debtor, filed in the United States District Court for the Southern District of New York, an original petition for an arrangement under Chapter XI, §322 of the Bankruptcy Act, 11 U.S.C. §722. On January 20, 1964, an Order was entered authorizing the Debtor to remain in possession of its property and to continue operation of its business. *Bankruptcy Act*, §§342, 343, 11 U.S.C. §§742, 743.

The Debtor operated its business as debtor in possession until November 9, 1964, when an order was entered adjudging the Debtor a bankrupt, directing that bankruptcy be proceeded with [Bankruptcy Act, §376(2), 11 U.S.C. §776 (2)] and appointing petitioner trustee. *Bankruptcy Act*, §§338, 378(2), 11 U.S.C. §§738,778(2).

In the course of operation of business by the debtor in possession in the abortive arrangement proceeding, the debtor in possession defaulted in its federal tax obligations in the following respects: failed to file timely tax returns, failed to pay certain taxes and failed to deposit in a depositary and obtain receipts for taxes withheld from employees.

The District Director of Internal Revenue filed an administration tax claim for $13,815.60. This amount included $2,786.36 in penalties assessed for the above delinquencies.

Petitioner filed an objection to the allowance of the penalties. The Referee sustained the objection, with an opinion dated January 25, 1967 (A14) followed by an order dated February 3, 1967.

The Director petitioned for a review of the Referee's order by the District Court, but that Court affirmed, with an opinion and order dated June 30, 1967 (A9). On the Director's appeal, the Court of Appeals reversed, with an opinion (A4) and judgment of May 10, 1968 (A8). This is the judgment sought to be reviewed here.

No issues of fact were involved in the Courts below.

Reasons for Granting the Writ

State of the Law

The question presented is one of first impression in this Court and in the lower Courts. In *Nicholas* v. *United States*, 384 U.S. 678 (1966), this Court found it unnecessary to determine the question. Id. at 693, n. 28.

In *Boteler* v. *Ingels*, 308 U.S. 57 (1939), the bankrupt estate was held liable to penalties for non-payment of California automobile license fees, the fees and penalties having accrued during operation of the bankrupt's business by the trustee himself. *Boteler* thus is of no help here, where the taxes and penalties were incurred not by the trustee but by the superseded debtor in possession in an arrangement proceeding.

In *Nicholas, supra,* one of the questions presented and decided was whether interest on tax claims against a debtor in possession is allowable for period beyond the date of bankruptcy adjudication, after terminatiton of the arrangement proceeding. The Court divided on the question, the majority holding that bankruptcy adjudication, after an arrangement proceeding, stops interest, just as interest is not allowed after the filing of a straight bankruptcy petition and there is no intervening arrangement. In arriving at this result the Court divided the proceedings into three periods, stating:

> "... the circumstances of the present case commend a division into three periods—the pre-arrangement period, the arrangement period, and the liquidating bankruptcy period. A tax incurred within any one of these three periods would, we think, be entitled to bear interest against the bankrupt estate until, but not beyond, the close of the period in which it was incurred ..." 384 U.S. at 686.

And the Court took occasion to add that it was not required "to collapse these important distinctions between an arrangement proceeding and a superseding bankruptcy" simply because §378(2) of the *Bankruptcy Act,* 11 U.S.C. §778(2), "provides that a bankruptcy proceeding

superseding a Chapter XI proceeding 'shall be conducted, so far as possible, in the same manner and with like effect as if a voluntary petition for adjudication in bankruptcy had been filed and a decree of adjudication had been entered on the day when the petition under this chapter (XI) was filed, '. . .'' 384 U.S. at 685, n. 13.

In *United States* v. *Paul Hardeman, Inc.,* 260 F. Supp. 723 (D.C. Fla. 1966), the Court applied the three-period formula of *Nicholas,* in holding that a cause of action which had accrued to a debtor in possession, and not barred at ensuing adjudication, may be timely instituted by the trustee within the two year limitation prescribed by §11e of the *Bankruptcy Act,* 11 U.S.C. §29e, measured not from the date the action accrued to the debtor in possession or the date of filing of the petition for arrangement, but from the date of adjudication.

In *Reading Co.* v. *Brown,* — U.S. —, 20 L. Ed. 2d 751 (June 3, 1968) the question was whether a tort claim against a receiver in an arrangement proceeding is an administration claim entitled to priority in the ensuing liquidating bankruptcy, as an ''actual and necessary'' cost and expense of preserving the estate, within the meaning of §64a (1) of the Bankruptcy Act, 11 U.S.C. 104a(1), which is made applicable to Chapter XI arrangements by §302 of the *Bankruptcy Act,* 11 U.S.C. §702. By a divided court the question was answered in the affirmative. This decision does not control the case at bar involving allowability not of a primary, principal claim but of an addition thereto, a penalty, based on considerations that are different.

Opinion of the Court of Appeals

The court below denied applicability of §57j, which disallows claims for penalties (A5), upon the ground that it applies only to pre-petition penalties. 394 F. 2d at 341. The treatment of this point is incomplete without considering the scope and effect of §302 of the *Bankruptcy Act,* 11 U.S.C. §702 (A1) which incorporates into Chapter XI other Chapters of the Act of which §57j is a part, and of other similar sections of the Act. The question was not actually presented in *Boteler* and it is not foreclosed by *Nicholas.* Nor did the court below give any consideration to the applicability here of the underlying equitable policy of § 57, emphasized and relied upon by the District Court (A12) and by the Referee (A16-17).

"Much more clearly relevant", held the court, is 28 U.S.C. § 960 [394 F. 2d at 342 (A6)], which subjects to Federal, State and local taxes any officers or agents conducting business under authority of a federal court. It is agreed that liability for taxes under that section necessarily carries with it liability for penalties, as *Boteler* held. But § 960 in terms subjects to taxes and, therefore, to penalties only the officer conducting business. It does not mandate the imposition of penalties upon another officer, who did not conduct business, for tax delinquencies of the one who did. § 960, therefore, actually supplies no answer to the question here presented. As stated in *Nicholas* with respect to the similar question of interest:

> "As an officer of the bankruptcy court, the debtor in possession was fully subject to taxes and interest incurred during his operation of business in Chapter XI arrangement. Nothing in the general language of 28 U.S.C. § 960, however, necessarily subjects the

trustee in the superseding bankruptcy proceeding to an obligation to pay additional interest on those prior taxes once a petition in bankruptcy is filed (citing cases". 384 U.S. at 690.

In support of its determination the court below held that "the general creditors who will, of course, ultimately bear the burden of the penalties continue as the same group before and after the adjudication. Replacing the debtor in possession with a trustee provides no basis for relieving the estate of the duty to pay these penalties." 394 F. 2d at 342 (A6-7). This pronouncement suggests an inseparable continuity of the arrangement and the following liquidating bankruptcy proceedings. And the court stated flatly that the *Nicholas* opinion "contains nothing suggesting that the result we have reached is incorrect" (394 F. 2d at 341 (A5). Since the separation and tri-partite division of the proceedings is the crux of the *Nicholas* opinion, the Court of Appeals has decided a federal question in a way in conflict with an applicable decision of this Court. *Rule* 19(1b), *Supreme Court Rules.*

§57j and its Policy

It is agreed that § 57j bars pre-petition penalties in straight bankruptcy proceedings. However, § 302 of the *Bankruptcy Act,* 11 U.S.C. § 702 makes applicable to Chapter XI proceedings, Chapter I to VII inclusive, "insofar as they are not inconsistent with or in conflict with" Chapter XI (A1). § 57j is part of Chapter VI and it is not inconsistent or in conflict with Chapter XI. See 9 *Collier on Bankruptcy,* § 7.07, p. 37; § 7.08, p. 40; § 7.10, p. 51.

> "The foregoing statutory provisions (Section 57a-k) are contained in Chapter X to VII of the Act. These

provisions are applicable to Chapter XI proceedings, with minor exceptions, because not inconsistent or in conflict with the provisions of Chapter XI.[18]

* * *

18. . . . Of the sections of Chapter I to VII referred to in the text, only 57h contains provisions not applicable in all Chapter XI procedings." 9 *Collier on Bankruptcy*, § 7.10, p. 56."

If Congress intended to exclude § 57j from applicability to Chapter XI, it would have so provided. Reserving the question here presented, this Court, in *Nicholas*, cited § 57j as one of the provisions relevant to consideration of it. 384 U.S. at 693, n. 28. See also § 381(3), 11 U.S.C. § 781(3) and § 378(4)c, 11 U.S.C. § 778(4)c, 1967 amendment (A2).

The underlying policy of § 57j is applicable to bar allowance in liquidating bankruptcies of penalties incurred by a debtor in possession.

> "The purpose of the provision is merely to protect general creditors against reduction of their dividend by reason of penalties or forfeitures owing by the bankrupt to the United States or any state or subdivision thereof . . . as 'sovereign'.
>
> * * * * *
>
> " . . . there is . . . the natural tendency and task of the bankruptcy law to mitigate as far as possible the losses to be sustained by creditors . . . It is this consideration for the bankrupt's creditors that pervades § 57j." 3 *Collier on Bankruptcy* (14ed.) § 57.22, p. 346.

Simonson v. *Granquist*, 369 U.S. 38 (1962) disallowed a tax penalty claim though it was secured by a lien. The Court there stated that "the broad aim of the Act" is

> "to provide for the conservation of the estates of insolvents to the end that there may be as equitable a

> distribution of assets as is consistent with the type of claims involved. . . . Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors". *Id.* at 40-41.

The § 57j policy against claims for penalties incurred prior to the filing of a petition in straight bankruptcy is fully applicable here under the "three-period" formula of *Nicholas*. Penalties, no less than accumulating interest, increase creditors' losses, whether they are incurred prior to straight bankruptcy or prior to adjudication following an unsuccessful arrangement.

Other Policy Considerations

The court below was encouraged in its decision by the hope that it "may well result in inducing the general creditors to interest themselves in the debtor in possession's promptly discharging his duties under the revenue laws and thus aiding in the proper collection of taxes which fall due during the arrangement period" 394 F. 2d at 342 (A7). The hope is unsound; it overlooks "the large arsenal at the Government's disposal for protecting and enforcing its own interests during an arrangement proceeding" [D.C. (A12-13)]. The Government's demands for revenue do not justify the inequitable shifting unto the creditors the burden of insuring collection, which is and in all justice ought to be the Government's own. And, in any event, the hope of creditors' aid in collection "assumes without documentation a measure of supervisory control by creditors which is scarcely to be taken as a standard and routine reality" [D.C. (A12)].

The court below expressed the apprehension that a result contrary to the one it reached "would have the practical effect of encouraging general creditors to seek an adjudication in bankruptcy in order to permit the estate to avoid the payment of penalties incurred by the debtor in possession". 394 F. 2d at 342 (A7). This apprehension is groundless; it misses the realties of the situation. A successful culmination of an arrangement would largely free the creditors from any interest in the estate and from any concern with penalties incurred by the debtor in possession. Acceptance of a plan of arrangement by creditors expresses a preference over a bankruptcy liquidation. A plan may not be confirmed unless the court is satisfied that "it is for the best interests of the creditors and is feasible." *Bankruptcy Act*, § 366 (2), 11 U.S.C. § 766. In the circumstances, to apprehend the seeking of an adjudication as an avoidance of penalties on the estate is to ascribe to creditors a senseless and perverse motivation to substitute a damaging liquidation for a beneficial arrangement.

The opinion below is less than adequate in its consideration of the issues presented. The applicability of § 57j and of its equitable policy to bar claims for penalties, in the context of the "three-period" formula of *Nicholas*, the court's failure to recognize and apply this controlling formula and the patent unsoundness of the policy considerations advanced in support of the result reached, all point to strong probability of error.

CONCLUSION

The question presented by this petition merits the attention of this Court. It is a question of first impression, important in the administration of the bankruptcy laws in cases where adjudication follows unsuccessful arrangement proceedings, of which "there are significant numbers". *Nicholas, supra,* 384 U.S. at 687 n. 16. The question is also important in the administration of the revenue laws in the context of bankruptcy and should be settled by this Court. For the foregoing reasons, this petition for certiorari should be granted.

Respectfully submitted,

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Applicable Statutes

Bankruptcy Act, § 57j, 11 U.S.C. § 93j.

Debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law.

Bankruptcy Act, § 302, 11 U.S.C. § 702.

The provisions of Chapters I to VII, inclusive, of this Act shall, insofar as they are not inconsistent with or in conflict with the provisions of this chapter, apply to proceedings under this chapter. For the purposes of such application, proceedings relating to 'bankrupts' shall be deemed to relate also to 'debtors', and 'bankruptcy proceedings' or 'proceedings in bankruptcy' shall be deemed to include proceedings under this chapter. For the purpose of such application the date of the filing of the petition in bankruptcy shall be taken to be the date of the filing of an original petition under Sections 322 of this Act, and the date of adjudication shall be taken to be the date of the filing of the petition under Section 321 or 322 of this Act, except where an adjudication had previously been entered.

Bankruptcy Act, § 342, 11 U.S.C. § 742.

Where no receiver or trustee is appointed, the debtor shall continue in possession of his property and shall have all the title and exercise all the powers of a trustee appointed under this Act, subject, however, at all times to the control of the Court and to such limitations, restrictions, terms

and conditions as the Court may from time to time prescribe.

Bankruptcy Act, § 343, 11 U.S.C. § 743.

The receiver or trustee, or the debtor in possession, shall have the power, upon authorization by and subject to the control of the Court, to operate the business and manage the property of the debtor during such period, limited or indefinite, as the Court may, from time to time, fix, and during such operation or management shall file reports thereof with the Court at such intervals as the Court may designate.

Bankruptcy Act, § 378 (4)c, 11 U.S.C. § 778 (4)c, 1967 amendment.

Upon the entry of an order directing that bankruptcy be proceeded with—

• • • • •

Upon the filing of the schedule and statement required by subdivision a of this section, the court shall make an order directing the claims against the debtor in possession, receiver or trustee, including all claims of the United States, any State, or any subdivision thereof, to be filed, and the holders of such claims to be notified to file their claims within sixty days from the date of the order. . . . Except as otherwise provided in this section, claims against the debtor in possession, receiver, or trustee shall be proved and filed in the manner provided in Section 57 of this Act.

Bankruptcy Act, § 381 (3), 11 U.S.C. 781 (3).

Where, after confirmation of an arrangement, the court shall enter an order directing that bankruptcy be proceeded with—

• • • • •

the provisions of Chapters I to VII, inclusive, of this Act, shall insofar as they are not inconsistent or in conflict with the provisions of this section, apply to the rights, duties, and liabilities of the creditors holding debts incurred by the debtor after the confirmation of the arrangement and before the date of the final order directing that bankruptcy be proceeded with, and of all persons with respect to the property of the debtor, and, for the purposes of such application, the date of bankruptcy shall be taken to be the date of the entry of the order directing that bankruptcy be proceeded with.

28 U.S.C. § 960

"Any officers and agents conducting any business under authority of a United States Court shall be subject to all Federal, State and local taxes applicable to such business to the same extent as if it were conducted by an individual or corporation."

Opinion of the United States Court of Appeals for the Second Circuit, May 10, 1968

Before HAYS, ANDERSON and FEINBERG, Circuit Judges.

HAYS, Circuit Judge:

[1] This is an appeal from a judgment of the district court which affirmed an order of the Referee in bankruptcy disallowing claims by the United States against the estate of a bankrupt for penalties for failure of the debtor in possession to make required deposits of withheld taxes and to file timely returns during an arrangement proceeding under Chapter XI which preceded the adjudication of bankruptcy. We hold that the penalties in question should have been allowed as a claim against the bankrupt estate.

There is no controversy as to the facts. On January 21, 1964 Samuel Chapman, Inc. filed a petition for an arrangement under Chapter XI of the Bankruptcy Act. Thereafter, and until November 9, 1964 when it was adjudicated a bankrupt, the petititoning corporatiton, under authority of the bankruptcy court, operated its business as debtor in possession. During the period of the pendency of the arrangement proceedings, the debtor in possession withheld federal income and social security taxes from the wages of its employees. It failed to deposit these withheld taxes and was also late in filing returns. For these derelictions it incurred certain penalties which the government sought to recover as a part of its claim against the bankrupt's estate. The trustee, who is the appellee in the present action, objected to the claim for penalties, and his objection was sustained by the Referee and by the district court on appeal from the Referee's order.

In seeking to support the result reached in the district court, much reliance is placed on Section 57(j) of the Bankruptcy Act, 11 U.S.C. § 93(j) which provides:

> "(j) Debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law."

[2, 3] That section does not apply to claims which arise after the initiation of proceedings under the Bankruptcy Act. There can be no doubt that the debtor in possession is liable for penalties incurred during its period of operation under the Act, just as the trustee is liable for penalties incurred after adjudication of bankruptcy. Boteler v. Ingels, 308 U.S. 57, 60 S.Ct. 29; L.Ed. 78, 432 (1939); Nicholas v. United States, 384 U.S. 678, 86 S.Ct. 1674, 16 L.Ed.2d 853 (1966). There is nothing in Section 57(j) which would lead to the disallowance of claims against the bankrupt estate of penalties incurred during the period when the debtor was in possession under a Chapter XI arrangement.

While the exact question presented here was expressly reserved in Nicholas v. United States, supra,[1] the opinion contains nothing suggesting that the result which we have reached is incorrect. On the contrary, the clear holding of the *Nicholas* case that tax penalties were claimable against

[1] 384 U.S. at 694 n. 28, 86 S.Ct. 1674, 16 L.Ed. 2d 853.

the trustee when combined with the fact that the taxes with respect to which the penalties were assessed were incurred by the debtor in possession under a prior Chapter XI arrangement proceeding involves a similarity of reasoning lending some support to our views. We find further support in Boteler v. Ingels, supra, 308 U.S. at pp. 59-60, 60 S.Ct. 29, at p. 31 where the Court vigorously rejected the applicability to a similar situation of Section 57(j).[2]

The provisions of Section 28 U.S.C. § 960 appear to us to be much more clearly relevant to the present situation than is Section 57(j). Section 960 provides;

"Tax Liability.

> Any officers and agents conducting any business under authority of a United States court shall be subject to all Federal, State and local taxes applicable to such business to the same extent as if it were conducted by an individual or corporatiton."

[4] Under this statute the debtor in possession is made fully subject to the penalties prescribed by the revenue laws and there is nothing to suggest that the liability for penalties is avoided by a subsequent adjudication in bankruptcy.

The general creditors who will, of course, ultimately bear the burden of the penalties continue as the same group before and after the adjudication. Replacing the debtor in possession with a trustee provides no basis for relieving the

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[2] "Subdivision 57(j) prohibits allowance of a tax penalty against the bankrupt estate only if incurred by the bankrupt before bankruptcy by reason of his own delinquency. After bankruptcy, it does not purport to exempt the trustee from the operation of state laws, or to relieve the estate from liability for the trustee's delinquencies."

estate of the duty to pay these penalties. Moreover it would be unfortunate to enunciate a rule which would have the practical effort of encouraging general creditors to seek an adjudication in bankruptcy in order to permit the estate to avoid the payment of penalties incurred by the debtor in possession.

On the other hand a rule under which the estate will remain liable for the tax penalties may well result in inducing the general creditors to interest themselves in the debtor in possession's promptly discharging his duties under the revenue laws and thus in aiding in the proper collection of the taxes which fall due during arrangement proceedings.

For the reasons given we reverse the determination that the bankrupt's estate is not liable for the penalties incurred by the debtor in possession. The government is entitled to interest on the penalties up to the date of adjudication of bankruptcy.

It appears from the government's brief that a part of the penalty claimed as an expense of the debtor in possession actually represented an alleged default by the trustee. This fact was "overlooked" in the prior proceeding. Since the point was not presented or passed on by the Referee or the district court, the case must be remanded to the Referee to give the trustee an opportunity to contest the claim.

Judgment of the United States Court of of Appeals for the Second Circuit, May 10, 1968

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the tenth day of May one thousand nine hundred and sixty-eight.

Present:

HON. PAUL R. HAYS,
HON. WILFRED FEINBERG,
HON. ROBERT P. ANDERSON,
Circuit Judges.

In the Matter of
SAMUEL CHAPMAN, INC.,
Bankrupt,

UNITED STATES OF AMERICA,
Appellant.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged and decreed that the judgment of said District Court be and it hereby is reversed and that the action be and it hereby is remanded to said District Court for further proceedings in accordance with the opinion of this Court with costs to the appellant.

A. DANIEL FUSARO
Clerk

Opinion and Order of the District Court for the Southern District of New York, June 30, 1967

FRANKEL, *D. J.*

This is a rare case, presenting, as Referee Herzog said, a "pure" question of law. The question, for which the particular facts are unimportant, is this:

> Is an estate in liquidating bankruptcy liable for federal tax penalties incurred by the debtor-in-possession during a superseded Chapter XI proceeding?

Affirming the referee's decision, the court concludes that the estate is not liable for such penalties.

The perimeters of the problem and main guides to decision, none of which yields a definitive answer, may be outlined as follows:

Section 57(j) of the Bankruptcy Act, 11 U.S.C. § 93(j), governing the proof and allowance of claims, provides:

> "Debts owing to the United States or to any State or any subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned thereby and such interest as may have accrued on the amount of such loss according to law."

It is common ground that the effect of the section is to erase only pre-bankruptcy penalties, *Boteler* v. *Ingels*, 308 U.S. 57 (1939), and it would appear to have this effect following commencement of a Chapter XI as well as a liquidating bankruptcy proceeding. It is likewise undisputed—though the scope of this proposition may be un-

certain since *Nicholas* v. *United States*, 384 U.S. 678, 694-95 (1966)—that an estate in liquidating bankruptcy is liable under *Boteler* for penalties incurred by the trustee during the period of his functioning.

Relying upon the concept, as expressed in *Nicholas*, that there is a "continuity of interest between the debtor in possession and the trustee as officers of the bankruptcy court" (384 U.S. at 693 n. 27), the Government argues that *Boteler* should be deemed controlling here. But the Supreme Court has refrained from joining in that view[1] and this court—focusing upon the rationale of *Boteler*, the teachings of *Nicholas*, and the pertinent policy of Section 57(j)—arrives at a contrary answer to this undoubtedly close question.

The Court in *Nicholas*, while it spoke of a "continuum," made clear that the flow of responsibilities and liabilities is not an uninterrupted one. In an analysis germane here, it divided the pertinent history "into three periods—the pre-arrangement period, the arrangement period, and the liquidating bankruptcy period." 384 U.S. at 686. The Court held that interest on taxes incurred during either of the first two periods accrues until the end of that period, but not beyond it. And it followed *Boteler* in exacting penalties from the estate for delinquencies of the trustee during the third period. In some persuasive measure, the rationale of *Nicholas*, including the reaffirmation of a central ground for decision in *Boteler*, points toward a result favoring the trustee in this case.

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[1] The question in the instant case was expressly reserved in *Nicholas*, 384 U.S. at 694 n. 28.

Explaining its conclusion that a trustee should not be immune from penalties for his tax defaults, the Court in *Boteler* pointed out that a contrary holding would strip from taxing authorities "the traditional and almost universal method of enforcing prompt payment." 308 U.S. at 61. In *Nicholas*, that point was stated as a central ground for reaffirming the *Boteler* rule. Quoting the foregoing language from *Boteler* (384 U.S. at 692), the Court stressed again that for the trustee's violation the Government was "entitled to exact the penalties * * * as a legitimate means to enforce the prompt filing of the tax returns." *Id.* at 694. It described the result in *Boteler* as one where "the trustee was penalized for *his* failure" (*Ibid.*, emphasis added) to perform his duty under the tax laws. And it concluded that a similar result should follow from "the trustee's failure to file timely returns" in the case before it. *Id.* at 695.

Three thoughts affecting the present problem emerge from reflection upon that analysis:

(1) Penalties serve as deterrents or as "encouragements" to compliance. To exact them from the person or entity responsible during any of the three periods supports "the traditional and almost universal" scheme of enforcement.

(2) No similar result is achieved by collecting penalties from the trustee for delinquencies committed by his predecessor in the Chapter XI period. In this respect, at least, the policy of § 57(j) is as potent with respect to that second period as it is for the first, pre-arrangement period.

(3) Absolving the trustee from penalties incurred by him creates an open-ended period of uncertain

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[2] Memorandum in Support of Petition for Review, p. 16.

> duration during which the coercive threat of such exactions is wholly suspended. No similar disarming of the taxing power results from confining the collectibility of penalties to the particular period in which they are incurred. The sanction of potential penalties is present and available at all times, throughout each of the three periods.

These premises do not lead mathematically or inexorably to a conclusion in this case. What they do show is that the judgment of policy underlying *Boteler* becomes severely weakened and diluted when the Government seeks its application to the different problem here. On the other hand, the fundamental and pervasive policy reflected in Section 57(j), which three Justices would have held sufficient to deny the penalties in *Nicholas* (dissent of White, J., in which Douglas and Fortas, JJ., joined, 384 U.S. at 696 *et seq.*), is correspondingly strengthened in its impact upon this case. That unquestioned policy—that "[t]he bankruptcy laws do not favor saddling an estate with penalties" (*id.* at 697)—would seem, therefore, to merit decisive weight for present purposes.

A brief comment is perhaps appropriate on the Government's suggestion that "[a]llowance of the penalties asserted herein will have the salutary effect of stimulating creditors' committees to actively supervise the debtor-in-possession's operations."[2] The point may not be weightless but it is in the end a small one. It assumes, without documentation, a measure of supervisory control by creditors which is scarcely to be taken as a standard and routine reality. It overlooks, moreover, the large arsenal at the Government's disposal for protecting and enforcing its own

interests during an arrangement proceeding. In short, it is not a factor of sufficient moment to overbalance the policy restricting the exaction of penalties at the expense of creditors.

The referee's order is confirmed. So ordered.

Dated: New York, New York
June 30, 1967

MARVIN E. FRANKEL
U. S. D. J.

Opinion of the Referee, January 25, 1967

ASA S. HERZOG, *Referee*

The question presented in this case is whether an estate in a liquidating bankruptcy may be subject to penalties previously incurred by the debtor-in-possession in a superseded Chapter XI proceeding. *Nicholas* v. *United States*, 384 U.S. 679 (decided June 13, 1966) does not rule this case. In footnote 28 at page 694 Mr. Justice Stewart, who wrote for the majority, stated:

> "Since it is clear that under § 6011(a) the trustee himself was required to file returns for the taxes in issue, we need not determine whether penalties incurred by the debtor-in-possession may be assessed against the trustee."

The facts are not in dispute:

A proceeding for an arrangement pursuant to Chapter XI of the Bankruptcy Act was initiated on January 21, 1964. The proceeding aborted on November 9, 1964, upon the entry of an adjudication in bankruptcy. In the interim, between January 21 and November 9, 1964, the debtor remained in possession of its property and was duly authorized to operate its business.

The debtor-in-possession incurred withholding and FICA tax liabilities but failed to purchase depository receipts biweekly and remit them to the Director of Internal Revenue. The debtor-in-possession also failed to file Employees' [sic] Quarterly Federal Tax Returns on July 31, 1964 and October 31, 1964, the last days of the months following the closing of the second and third quarters of 1964.

Based upon these omissions the proof of debt filed by the Director of Internal Revenue in the bankruptcy proceeding includes penalties aggregating $2,786.36. The trustee filed objection to the allowance of the penalties. Both sides have agreed that the controversy be submitted for decision as a pure question of law.

Pre-bankruptcy penalties are not allowable in a bankruptcy[1] by virtue of § 57j of the Act which, so far as is material, provides:

> "Debts owing to the United States or any State or any subdivision thereof as a penalty or forfeiture shall not be allowed. . . ."

But § 57j is of no help in answering the question *sub judice* since its applicability is limited to penalty claims which arose prior to the filing of a petition initiating a proceeding under the Act, *Boteler* v. *Ingels*, 308 U.S. 57 (1939).

It is perfectly true that Title 28 U.S.C. 960 clearly makes a debtor-in-possession operating the business pursuant to the order of the bankruptcy court subject to taxes as in the case of any individual or corporation.[2] And, if

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[1] Section 57j was held applicable to penalties incurred prior to a reorganization pursuant to § 77, *In re Denver & R.G.W.R. Co.*, 27 F. Supp. 983 (D.C. Colo. 1938), and to penalties incurred prior to a Chapter X proceeding, *In re Hankey Baking Company*, 127 F. Supp. 683 (W.D. Penna. 1954). There is no doubt that the section is applicable to penalties incurred prior to an arrangement proceeding under Chapter XI. Chapters I-VII of the Act are applicable to Chapter XI unless inconsistent (Bankr. Act § 302). No inconsistency is apparent.

[2] "Any officers and agents conducting any business under authority of a United States court shall be subject to all Federal, State and local taxes applicable to such business to the same extent as if it were conducted by an individual or corporation." 28 U.S.C. 960 (1964 ed.).

subject to taxes, the estate is subject to penalties, the traditional and almost universal method of enforcing prompt payment, *Boteler* v. *Engels, supra.*

But it does not of necessity follow that such debtor-in-possession penalties penetrate the wall of a subsequent adjudication and attach to the estate now in ordinary bankruptcy. A Chapter XI proceeding undoubtedly closes the door in the face of a pre-petition penalty. I think that a subsequent adjudication has a like effect upon a penalty incurred in a prior Chapter XI proceeding.

I do not view the trustee in bankruptcy in the character of a successor trustee to whom attaches all the liabilities of the debtor-in-possession. While they are both officers of the court (*City of New York* v. *Rassner,* 127 F.2d 703), the debtor-in-possession is merely *analogous* to a trustee,[3] [*Wil-Low Cafeteria Inc.,* 111 F. 2d 82 (2d Cir. 1940)]. There is no basis in law for treating the debtor-in-possession and the trustee as one person, *Nicholas* v. *United States, supra* (dissenting Op.).

The bankruptcy laws look with disfavor upon saddling a bankrupt estate with penalties. The general policy is against thus diluting the claims of creditors. The very equitable character of the bankruptcy court operates against carrying the debtor-in-possession's penalty into the superseding bankruptcy liquidation.

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[3] Section 342 of the Act (11 U.S.C. 742) merely provides that the debtor-in-possession "have all the title and exercise all the powers of a trustee appointed under this Act"—a far cry from constituting him unqualified as a trustee!

As contrasted with a tax, a penalty has essentially a different aim, its prime purpose being to regulate conduct rather than produce revenue, *In re Standard Compositions,* 23 F. Supp. 391 (D.C. Mich. 1938). The tenor of the law, in the interest of public policy, is aimed to preserve the bankrupt estate from the imposition of penalties which would fritter away its assets, *In re Hankey Baking Company, supra,* n. 1.

The Director makes reference to *City of New York* v. *Rassner,* 127 F. 2d 703 (2d Cir. 1942); *Hercules Service Parts Corp.* v. *U. S.,* 202 F. 2d 938 (6th Cir. 1953) and *United States* v. *Sampsell,* 193 F. 2d 154 (9th Cir. 1951). These cases and *In re Airline Arista Printing Corp.,* 267 F. 2d 333 (2d Cir.) are bottomed upon the rationale that all the assets in the superseding bankruptcy were trust funds to satisfy governmental claims which arose during the Chapter XI proceeding. The thrust of this reasoning is that creditors would receive no less than that to which they were originally entitled, and that which would have been received if the debtor-in-possession had performed his obligation. Any other course of action would lead to an inequitable result.

But this argument is not valid when related to penalities incurred by a debtor-in-possession, for in such case, imposition of the penalty reduces the amount which would otherwise be available for creditors had the debtor-in-possession, an entirely different entity, performed its obligation. This, I think, would lead to an inequitable result.

Where, as in *Nicholas,* a trustee incurs penalties *for his own act or failure to act,* the creditors can hardly be heard

to complain if the trustee of their choice (or one appointed for them by the court because of their apathy) is negligent. Moreover, a trustee whose omission results in a loss to the estate may be surcharged, thus making the estate whole. Such remedy would not be available against a debtor-in-possession.

It seems to me that weighty and persuasive reasons should be required for imposing upon the estate a penalty incurred by the debtor-in-possession who, although clothed with the title "debtor-in-possession", is still, to the general creditor body, the same person who filed the Chapter XI proceeding in the first instance.

Although Section 57j may not apply to penalties incurred in the debtor-in-possession period, I am convinced that its philosophy does. I think that the bankruptcy court, in the proper exercise of its equity powers should extend the effect of § 57j and bar all claims for penalty, whether incurred prior to the ill-fated arrangement proceeding, or during the pendency thereof.

The motion will be granted and the penalty portions of the Director's claim will be expunged. Settle order on five days notice.

Dated: New York, New York
January 25, 1967.

Asa S. Herzog
Referee in Bankruptcy